Abstract

The crisis facing Japan’s banking sector has been attributed to a wide range of factors: (1) the run-up and collapse of the bubble; (2) a lack of adequate supervision of financial institutions by the government; (3) the stagnation of the economy, because the Japanese growth model is no longer relevant; and (4) bad management of the banks. It is important to reform corporate governance in the real sector, not merely in the financial sector. It should also be recognized that Japan’s financial system should reduce the size of the safety net provided by the government not only through the deposit insurance system, but also through the enormous postal savings business.

1. Japan’s banking sector: Nonperforming loans and other risks

Since the mid-1990s, the Japanese banking sector has experienced its worst crisis since Japan began to modernize after 1968. The nonperforming loan (NPL) problem lies at the center of the crisis and casts a cloud over the revitalization of Japan’s economy. By the end of 2000, Japanese banks had disposed of some ¥68.6 trillion in NPLs (Bank of Japan 2000). The information disclosed under Japan’s Financial Reconstruction Law suggests that Japanese banks are still encumbered with NPLs amounting to approximately ¥30 trillion, which represents 6.4 percent of the value of all bank loans and 5.8 percent of GDP. Several major Japanese banks have been drawing on their legal re-

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Figure 1. Distribution of Risk Management Loans by industrial sector


Note: Figures in parentheses are the shares of Risk Management Loans held by each sector. Figures for the outstanding Risk Management Loans within each sector (as of the end of March 1999) and the share of Risk Management Loans in total lending for each sector (as of the end of March 1999) are based on the accounts of the 31 banks that disclosed Risk Management Loans by industrial sector both at the end of March 1999 and the end of March 2000. The figures for the outstanding Risk Management Loans within each sector (as of the end of March 2000) and the share of Risk Management Loans in total lending for each sector (as of the end of March 2000) are based on the accounts of the 62 banks that disclosed risk management loans by industrial sector at the end of March 2000.

serves to pay the dividends due on the public funds injected to date. Tapping their reserves is necessary because, under the country’s Early Strengthening Law, if a bank does not pay the dividends owed to the priority shares held by the government, the government will acquire voting rights, and hence be able to increase its intervention in the bank’s affairs. Thus, the NPL problem has seriously weakened Japanese banks.

A Bank of Japan (2000) survey, by industrial sector, of Risk Management Loans (the definition of which is virtually identical to that of loans that must be disclosed under the Financial Reconstruction Law) reveals that the real estate, services, wholesale, and construction sectors account for the largest part of the problem. These sectors’ combined Risk Management Loans account for about 77 percent of the total (figure 1). During the bubble period, Japanese bank lending grew at a rate well above that of nominal GDP. These four sectors experienced particularly rapid lending growth at the time, and the bursting of the bubble has left them burdened with
excessive debt. The Japanese economy has remained sluggish since the bubble burst in 1990–91, and some observers believe that a new phase has begun in which, over the next few years, sectors with low productivity that have been unable to restructure will have to close, and consequently new bad loans will arise.¹ This process appears to be under way already. The Bank of Japan’s survey suggests that virtually all existing NPLs are “new bad loans.” (See Bank of Japan 2001a.)

The risks facing the Japanese banking sector are not confined to credit risks, such as the risk of business failure. The banking sector also holds a large volume of shares in business corporations and is therefore exposed to the risk presented by the fluctuation of the price of these shares. Given the scale of the risk attendant on share holding (table 1), the Financial Council of the Financial Services Agency has proposed voluntary risk management by banks with regard to their share holdings. Beginning in 2004, banks will be required to limit their holding of shares to no more than their net worth (Tier 1 capital of the Basle Capital Accord). Moreover, the sluggish demand for funds from the business sector has forced banks to shift their asset portfolios toward holding a higher percentage of government bonds. This exposes banks to additional risks, because if long-term interest rates rise, then the banking sector may experience capital losses (figure 2).

2. Background to the banking crisis and prospects for survival

The crisis facing Japan’s banking sector has been attributed to a wide range of factors. The more important include the following: (1) the run-up and collapse of the bubble, which resulted from the failure of macroeconomic management; (2) a lack of adequate supervision of financial institutions by the government; (3) the stagnation

¹ For a more detailed account of the structural problems facing the Japanese economy, see Murayama (1999).
of the economy because the Japanese growth model is no longer relevant; and (4) the nontransparent practices of Japanese banks.

Iwamura and Okina (1998) point out that a narrow perception of the NPL problem would put the blame for the problem on the inability of Japanese banks to cope with environmental changes in the 1980s. During the period of rapid economic growth, when Japan had a shortage of national savings and an excess of investment opportunities, banks simply distributed the scarce funds to the business sector in an even-handed manner. Because there was little attention paid to evaluating or monitoring risk, the banks experienced an increase in the number of bad loans when the economy slowed after 1990. This view would also blame the regulatory authorities, who paid little attention to the lending practices of the banks and the shift in environment.

A broader perception of the NPL problem would characterize it as only one aspect of a deeper and more intractable problem facing Japan’s banking system. The banking system in Japan has been slow to adapt to the global changes in the banking world that have resulted from deregulation and innovations in financial technology,

Horiuchi and Hanawa (2000) argue that the main factor driving the banking crisis is the “internal collapse” of the banking system because of the misjudgment and imprudent actions of the banks and their supervisors.
and slow to respond to the rapid changes in client needs against this background. This slow adjustment is partly a result of the strict regulations imposed by the Ministry of Finance on the scope of bank activities until the 1990s. These regulations encouraged banks to channel an excessive proportion of their business resources into taking deposits and lending. Over-banking in the financial system (i.e., too much retail banking, as exemplified by the large postal savings system, to be discussed in section 4) caused a decline in profitability, and the narrow business portfolios caused a decline in the banks’ ability to bear risk.

Does Japan’s banking system still have the strength to overcome these difficulties? Some maintain that the ¥1,400 trillion in individual assets still held in Japan can be counted as a strength of the financial system. This view is overoptimistic, however. Within the context of rapid innovation in financial technology, the simple presence in Japan of a vast sum of assets can no longer be called a strength.

In the 1980s, the global current of deregulation that occurred in the midst of the information and telecommunications revolution led to the “financial unbundling” of financial transactions. Financial unbundling separates the management of funds from the management of information, so that the two functions can be offered to clients separately (Iwamura 1996; Merton and Bodie 1995). With the separation of fund management and information management, the vast savings in Japanese banks are no longer a guarantee of income. Against a background of the Bank of Japan’s zero-interest policy and the cost of deposit insurance premiums, in addition to the cost of paying interest on deposits, Japanese banks are having trouble being profitable.

The most profitable part of financial services is no longer the simple management of funds, but the evaluation of investment opportunities. The banks are increasingly being called upon to play the new role of managing risks for the assets of the household sector. This transformation of the financial services industry into an “information industry” opens the banks to an unprecedented degree of international competition. It would be wrong, however, to claim that Japanese banks have been decisively outdistanced in the race to develop the technology necessary for survival in an era of international competition. Given that Japan’s competitive advantage lies in the command of intellectual labor resources, then as long as it is possible to transform business management to draw maximum advantage from these resources, it would be premature to take an entirely pessimistic view of the future of Japan’s financial sector.

Following the enactment of the Early Strengthening Law in 1998, a huge amount of capital was injected into the financial system to restore the soundness of the financial functions of a wide range of financial institutions, from major national banks to
small credit unions. This injection of capital has helped relieve the financial anxiety and the credit crunch resulting from the nonperforming assets, but it has not been enough to resolve the problems of the financial system outright, and it has put off a long-term resolution of these problems. The following problems have come to light in connection with the public funds injected into the system in 1999:

- Because the injection of funds was based on the assumption that the recipient banks were sound, the obligation of directors and shareholders to act responsibly was not made explicit, and the injection of funds provided no incentive to reform management.
- The funds were positioned as equity capital but were similar to a liability, and the assumption was that they would eventually be repaid. As a result, the new capital could not be used directly for the losses incurred in disposing of nonperforming loans, and this outflow of funds, in conjunction with the payment of dividends to the government, further weakened the recipient banks.
- The requirement that recipient banks provide credit to small businesses distorted business management by forcing banks to lend to unprofitable companies, despite the obligation to improve their own profitability.
- The recipient banks have failed to earn returns proportional to the risks attendant on competition because of over-banking and the requirements to extend credit to small firms. The presence of government financial institutions for small business (such as the National Finance Corporation and the Japanese Finance Corporation) have made it difficult for recipient banks to become profitable, because these institutions offer very low interest rates that the smaller banks are unable to match.

As a result of these problems, the recovery in Japanese banks’ business performance was temporary, and it is unlikely that the banks, in the near future, can repay the funds they received. The injection of public funds in 1999 did not address the problems of excessive retail banking (over-banking) and poor management. It merely postponed ultimate resolution of the NPL problem and the structural problems of the banking system.

The implementation of vigorous measures against NPLs (including the accumulation of allowance for loan loss) and the bringing forward of liquidation of NPLs is

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3 According to Hoshi and Kashyap (1999), Japanese banks are competing so fiercely to lend to blue-chip companies that credit spreads have become unusually narrow.
4 See Fukao and Japan Center for Economic Research (2001b).
5 Yamaguchi (2001) argues that the mutual dependence of banks and companies in Japan is one of the reasons that Japanese banks are not profitable. In a weak economy, if banks drastically increase the credit spread, their borrowers are likely to go bankrupt and the banks will suffer in the end.
said to be one important reason that American banks were able to overcome the problem of NPLs in the 1980s. The effectiveness of these measures was increased by an overall improvement in the U.S. economy and advances in financial technology. Accordingly, at a micro level, the Japanese banks should focus on offering clients a wide range of financial services (utilizing innovations in information and telecommunications technology) and improving risk management. It is also important to reform corporate governance in the real sector, not merely in the financial sector. At a macro level, economic policy should give priority to putting the economy back on the road to sustainable growth.

3. Transition to limited-coverage deposit insurance

One reason that depositors in Japan have not discriminated between sound and unsound banks (hence helping unsound banks to survive) is because they have regarded bank deposits as guaranteed (explicitly and implicitly) by the government. It is therefore important to note the special measures for the protection of the full amount of deposits in Japan, which were introduced in late 1995 and partially expired on 1 April 2002 (table 2). Limited-coverage deposit insurance was imposed only on nonsettlement balances, such as time and saving deposits, but the most important balances from a transactions perspective are covered until 31 March 2005.6 Beginning in April 2002, the failure of a financial institution could cause large depositors (those with deposits of ¥10 million or more) to suffer losses as a result of the failure. This was intended to encourage large-scale depositors to scrutinize the soundness of banks in which they hold deposits, which would in turn encourage the banks to improve their business management (Financial Services Agency 1999). In other words, the intention was to create a small safety net so as to stimulate market discipline and encourage independence among participants in the financial system.

An analysis of deposit data reveals that deposits for settlement purposes are growing and that the decrease in the amount of term deposits above ¥10 million has been very large (table 3). A sluggish economy and the poor performance of money market funds, a number of which fell below par value in the autumn of 2001, have led to a stagnation of investment in investment trusts and shares, and investors are showing a greater preference for safety. One noteworthy development in recent months is a significant increase in the rate at which investors are shifting their savings to postal transfer accounts (figure 3). In the medium to long term, it is likely that the transition to limited-coverage deposit insurance will rebuild the indirect-finance

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6 It was decided to postpone the 1 April 2003 limit on settlement balances to April 2005 and introduce a full guarantee for non-interest-bearing settlement balances in November 2002.
sector (the traditional business of deposits and loans), reduce the dependence of banks on indirect finance, and create a system in which indirect finance involves lower maintenance costs (Okina 2002).

4. Need for a review of the postal savings business

One major challenge to reforming Japan’s financial system is to reduce the size of the safety net provided by the government through Japan’s enormous and unique postal savings business. Postal savings are the means of saving dearest to the hearts of the Japanese people, but the scale of the business casts a cloud over the financial system as a whole. Postal savings are deposits guaranteed by the government, and they account for approximately 20 percent of all financial assets of the Japanese household sector. The postal savings system allocates such a large amount of financial wealth through indirect markets that it effectively limits the development of money and capital markets. The postal savings system has traditionally served to channel the savings of the Japanese people into the Fiscal Investment and Loan Program (FILP). This function of the system was useful to some extent in wartime Japan and during the period of rapid economic growth. However, the growth of pri-

### Table 2. Schedule for transition to limited-coverage deposit insurance

<table>
<thead>
<tr>
<th>Deposits within the scope of protection</th>
<th>Until the end of March 2002</th>
<th>April 2002 to the end of March 2005</th>
<th>April 2005 onward</th>
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</thead>
<tbody>
<tr>
<td>Current deposits, ordinary savings, and miscellaneous deposits</td>
<td>Entire amount protected</td>
<td>Entire amount protected</td>
<td>Entire amount of non-interest-bearing accounts protected</td>
</tr>
<tr>
<td>Other deposits: time deposits, installment savings, money in trust under the guarantee of principal and bank debentures</td>
<td>Entire amount protected</td>
<td>Total amount up to a maximum principal of ¥10 million plus interest</td>
<td>Total amount up to a maximum principal of ¥10 million plus interest</td>
</tr>
</tbody>
</table>

**Deposits outside the scope of protection**

| Foreign currency deposits, negotiable certificates of deposit, money in trust under no guarantee of principal, and bank debentures (other than safe deposit instruments) | Entire amount protected | Insurance payable in accordance with asset situation of failed financial institution (may be subject to deductions) | Insurance payable in accordance with asset situation of failed financial institution (may be subject to deductions) |

**Source:** Financial Services Agency (1999).

a. By law, the special arrangement to protect the entire amount of deposits requires that an application for financial assistance has been submitted to the Deposit Insurance Corporation and that other procedures have been carried out by the end of March 2002.
b. Deposit principal exceeding ¥10 million plus interest is payable as liquidated claims in accordance with the asset situation of the failed financial institution and may therefore be subject to deductions.
c. “Money in trust” is money that has been received through a trust agreement pertaining to money in trust (including loan trusts).
d. Those debentures for which the rights holder can be confirmed by safe deposit agreement.
vate sector financial organizations and the creation of the deposit insurance system has rendered the link between the postal savings system and the FILP unnecessary. It was therefore natural that, in 2001, the direct connection between the two was abolished.

The postal savings business competes directly with private sector financial institutions, particularly in the fields of absorbing small deposits by individuals and settle-
ments, but it is exempt from tax, deposit insurance contributions, and reserve deposit requirements and thereby has a clear competitive advantage over the products offered by private sector financial institutions. The problem of competition between the postal savings business and private sector financial institutions will become even more one-sided when the coverage provided by deposit insurance changes and deposits with private sector financial institutions are protected only up to a principal of ¥10 million and the interest thereon. There is, of course, a limit of ¥10 million yen on postal savings deposits, but depositors may take advantage of the fact that the system is not capable of promptly checking the total amount in the accounts of a single depositor. Table 4 reveals that even though all deposits with private sector financial institutions were guaranteed when the Hokkaido Takushoku Bank and the Hanwa Bank failed, there were shifts of funds to postal savings (see Cargill and Yoshino, forthcoming).

It should be recognized that the postal savings system has an important potential for financial instability. *Teigaku* savings, the interest on which is fixed for 10 years, are an extremely attractive product in that they offer the holder a “put option” whereby they can be surrendered, after a period of six months, at the interest applicable at the time of deposit, and redeposited at a new rate. The structure of *teigaku* savings, however, makes it difficult for the postal savings system to manage assets and liabilities. If the postal savings business were to fail in its operation of funds or incur a loss resulting from a significant change in interest rate conditions, taxpayers would be exposed to risk. The scale of the funds involved means that self-operation may also have a significant impact on the trend of interest rates and liquidity of the government bond market and on the short-term financial markets.

The double whammy of unfair competition from the postal savings business and the high levels of NPLs makes it unlikely that Japan’s private financial sector can recover on its own in the short run (if ever). It is therefore vital that the government review the raison d’être and methods of management of the postal savings business and set about reforming and privatizing the system without delay.7

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7 As for the plan for privatizing the postal savings system, see Fukao and Japan Center for Economic Research (2001a), Ikeo (2000), and Okina (2001). The three postal businesses (postal savings, life insurance, and postal services) will become public corporations in 2003. A discussion group under Prime Minister Junichiro Koizumi is considering the future of the three privatized postal businesses and published a report on 6 September 2002.
Table 4. Trends in postal savings in times of financial crisis (percentage change)

<table>
<thead>
<tr>
<th></th>
<th>National average</th>
<th>Hokkaido</th>
<th>Wakayama Prefecture</th>
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</thead>
<tbody>
<tr>
<td>Growth of outstanding balance of postal savings in fiscal 1997</td>
<td>6.96</td>
<td>9.15</td>
<td>10.23</td>
</tr>
<tr>
<td>Growth of outstanding balance of deposits by individuals at private financial institutions in fiscal 1997</td>
<td>6.29</td>
<td>0.73</td>
<td>−5.63</td>
</tr>
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Note: In the case of Hokkaido, the Hokkaido Takushoku Bank failed in November 1997. In the case of Wakayama Prefecture, the Hanwa Bank failed in November 1996.

References


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